IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

NO. 77-204

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, HOFMANN, KAVANAUGH COMMODITIES CORP., INC., as Successor In Interest to First Western Commodity Options, Inc. of Los Angeles, A. L. & T. TRADING, INC., CHARTERED SYSTEMS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST COMMODITIES CORP. OF BOSTON, INC., INTERNATIONAL TRADING GROUP, LTD., LONDON FUTURES, LTD., AND WILLISTON CORPORATION,

Petitioners,

v.

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman; COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman; COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissoner; COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner; COMMODITY FUTURES TRADING COMMISSION; and ROBERT L. MARTIN, Commissioner, COMMODITY FUTURES TRADING COMMISSION,

Respondents,

REPLY TO BRIEF FOR RESPONDENTS IN OPPOSITION

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REPLY TO BRIEF FOR RESPONDENTS IN OPPOSITION

Now come the petitioners National Association of Commodity Options Dealers ("NASCOD"), and certain members firms thereof, hereinafter sometimes collectively known as

"Petitioners", and hereby reply to the Brief For Respondents in Opposition ("Opposition Brief") filed on behalf of the respondents Commodity Futures Trading Commission and individual members thereof ("Commission"). The Opposition Brief fails to demonstrate that this Honorable Court should not issue a writ of certiorari to the United States Court of Appeals for the Second Circuit ("Court of Appeals") to review the Judgment and Opinion entered in this action on April 4, 1977, as to the reversal of the preliminary injunction and the premature grant of summary judgment on the issue of the lawfulness of Commission Regulation 32.6, 17 C.F.R. 32.6 (1976), and does not refute the careful argumentation set forth in the original Petition for a Writ of Certiorari ("Petition"), filed on August 5, 1977.

The Commission commences its argument by stating that the decision "did not create any conflict among the Courts of Appeals" (Opposition Brief, p. 10). This statement is accurate in that the decision at issue here is the first review by any Court of Appeals of the regulations promulgated by the new Commission, but is completely irrelevant to the case at bar. It is clear, as the Opposition Brief states, that a number of United States District Courts have enjoined the enforcement of the Regulation (Fn 5, pp. 9-10). These Courts are located in four (4) different Circuits; the Fifth Circuit (*Frankland Commodities Corp. v. Commodity Futures Trading Commission,* N.D.Ga., No. C-77-643 A); the Second Circuit (*Dorchester Commodities Corp. v. Commodity Futures Trading Commission,* S.D.N.Y., 77 Civ. No. 3958 (two firms); *Neuberger Securities Corp. v. Commodity Futures Trading Commission,* S.D.N.Y., 77 Civ. No. 3048; *Transocean Commodity, Ltd. v. Commodity Futures Trading Commission,* S.D.N.Y., 77 Civ. No. 4060); the Tenth Circuit (*London Commodity Options, Ltd., v. United States,*

D.Utah No. C-77-0293), and the District of Columbia Circuit (*Murlas Brothers Commodities, Inc., v. Commodity Futures Trading Commission*, No. C.A. 77-1473). These injunctions have all been issued since the decision by the Court of Appeals. This multiplicity of subsequent decisions adverse to the Commission calls the decision of the Court of Appeals into question, and indicates that the lawfulness of "double segregation" is an important federal matter, which this Honorable Court should resolve. *See, Shapiro v. United States*, 335 U.S. 1, 4 (1974).

The Opposition Brief argues that this Honorable Court should not grant review in that "routine Commission inspections of fourteen of the approximately sixty firms selling options have established that twelve of these fourteen were complying substantially with the regulations," and that therefore "double segregation" may not have the deleterious effect claimed by Petitioner. (Opposition Brief, p. 10-11). This statement is an attempt to introduce unverified factual material into this proceeding long after the closing of the record. Furthermore, these factual allegations have not been tested in the crucible of litigation, so Petitioners do not know the nature of these inspections, or are even certain of the identity of the twelve firms.

Although the Opposition Brief does not identify the "twelve of the fourteen" inspected firms who are supposedly in compliance with double segregation, they are probably the same 12 of the other firms complying with double segregation indicated in Footnote 7, page 7, of the Commission's Motion to Vacate Stay of the Mandate filed with Mr. Justice Marshall. Of those dozen listed firms, Clayton Brokerage Co. of St. Louis, Ltd., International Precious Metals Corp., Madda Trading Co., Shearson Hayden Stone, Inc., and Siegel Trading Co. Inc., are

diversified wire houses or firms which do not do a significant part of their business in retail sales of London options. Crown Colony Options, Ltd., has since been absorbed by Neuberger Securities Corp., and accordingly, now enjoys court protection. *Neuberger Securities Corp. v. Commodity Futures Trading Commission, supra.* Both London Commodity Options, Ltd., and United Kingdom Commodity Options, Ltd., have obtained their own preliminary injunctions against having to double segregate further. *Dorchester Commodities Corp. and United Kingdom Commodity Options, Ltd., v. Commodity Futures Trading Commission, et al., supra, London Commodity Options v. United States, supra.*

Rothschild Commodities, Inc., had originally obtained court protection by intervening in *Frankland Commodities Corp. v. Commodity Futures Trading Commission, supra.* Thereafter, Rothschild withdrew from the action and was absorbed by Rosenthal & Co., another firm the Commission lists as being substantially in compliance with double segregation. Rosenthal & Co. in turn is the subject of both a massive civil injunctive anti-fraud action and an administrative proceeding brought by the Commission. *Commodity Futures Trading Commission v. Rosenthal & Co.*, (N.D. ILL. Civil Action No. 76-C-3904); *Commodity Futures Trading Commission v. Rosenthal & Co.*, CFTC Docket No. 77-10. Certainly therefore, this selection of firms does not indicate that an ethical options specialty firm can survive double segregation. Rather, it strongly indicates the contrary.

Moreover, even the Commission in the October 8, 1976, Federal Register Notice admitted that the Regulation would impose a "financial hardship on affected firms". 41 Fed. Reg. 44562. Mr. Justice Marshall in rejecting the application of the

Commission to dissolve the stays of the mandate in this proceeding specifically noted:

> "If and when the Regulation does go into effect, respondents may well be driven out of business, and on this basis the District Court expressly found that respondents are threatened with irreparable harm" *C.F.T.C. v. British American Commodity Options Corp.*, CCH Com. Fut. L. Rep. P. 20, 458, page 21, 888.

The Opposition Brief characterizes the double segregation requirement as a "temporary" measure, and states that "review by this Court of the present case would be premature" (p. 13). This Honorable Court should not deny certiorari on the basis of the Commission's representation that Regulation 32.6 may be repealed at some unspecified later date. The Regulation was originally due to become effective on December 27, 1976, over ten (10) months ago, and the Commission is under no obligation whatsoever to repeal or revise it. The Commission stated that it would "shortly propose" second phase regulations as early as the October 8, 1976, Federal Register Notice which first set forth the "double segregation" requirement. 41 Fed. Reg. 44561. Although, as the Opposition Brief states, proposed new Regulations for options trading were published on April 5, 1977, 42 Fed. Reg. 18246, the latest set of such proposed regulations were not published in the Federal Register until October 17, 1977. 42 Fed. Reg. 55538 *et seq.*, and these are substantially different from the earlier proposed regulations. This latest set of proposed options regulations are subject to comments until December 1, 1977, and no proposed effective date has even been set. 42 Fed. Reg. 55538.

Moreover, there is no indication that new regulations will ever be adopted in the proposed form, or otherwise. In fact, at

the Commission's hearing on the proposed regulation (which has not been transcribed to Petitioner's knowledge) several of the Commissioners had grave doubts as to the legal effic cy of the proposed regulations, but voted for their publication for the purpose of eliciting industry comment. There is still no indication when – or if – superseding regulations will be effective "double segregation" repealed.

Moreover, the fact that the Regulation may not be intended as a permanent fixture should not preclude review. Any agency has the right to change any of its regulations at any time. Any agency could escape judicial review of its regulations by merely claiming that at some point it will promulgate superceding rules. At some point, an agency's characterizing its regulations as "interim" should be construed as a misleading label. In view of the actual longevity of the Regulation, its inarguable harshness, and the multiple contested litigation it has engendered, it is disingenuous in the least for the Commission to claim that judicial review of this Regulation by this Honorable Court is "premature" at this juncture.

The Commission next alleges that the segregation imposed by Regulation 32.6 17 C.F.R. 32.6 (1976) is neither novel nor unusual, but rather analogous to the segregation of a futures customer's funds received by a firm to margin, guarantee or secure the trades or contracts of such customer in special accounts as required by Section 4d(2) of the Commodities Exchange Act, as amended ("The Act"), 7 U.S.C. 6d(2) (Supp. V (1975)). However, the Commission was well aware, at the time, in promulgating the original regulation 32.6, that it imposed a requirement which went far beyond the traditional limited segregation:

"As noted above, the Commission is aware that proposed Section 32.6 may in certain cases, require 'double segregation'. For example, in the case of the sale of London Options, a person receiving the funds from an option customer in the United States as payment for the option may not remit those funds to London in order to obtain or maintain the option position with the London broker." 41 Fed. Reg. 44562.

Mr. Justice Marshall also explained that Regulation 32.6 was a significant departure from the earlier procedure.

"...It does appear that the Regulation would fundamentally alter the ground rules for doing business in a substantial industry, with potentially fatal consequences for a number of the firms currently in the trade, and this case presents the first opportunity for this Court to pass on action taken by the recently created Commission." *C.F.T.C. v. British Commodity Options Corp., supra,* P. 21,889.

The Commission next states that options firms should be able to survive double segregation by borrowing the funds required to purchase the options. (p. 14-16). This argument by the Commission ignores the reality that a financial institution will not lend the vast amounts of money necessary to finance double segregation, as the Commission has taken the position that segregated funds are not collateralizable, and the Regulation is not clear when such funds can be released. *See, Murlas Brothers Commodities, Inc., v. C.F.T.C., supra,* CCH Com. Fut. L. Rep. P. 20,483, pp. 21, 968-69. The District Court in this case specifically found that the Commission suggestion that double segregation could be "accomplished by bank

financing is not persuasive," (Petition p. A. 49.), and no evidence to rebut this finding has ever been entered in the record of this proceeding in that the Commission has never been able to show even one firm that can meet the burden of double segregation through bank financing.

The Opposition Brief next argues that a customer might well have a claim to segregated funds in the event of an options firm's insolvency, and that therefore the double segregation requirement could accomplish its stated purpose (Opposition Brief p. 19-20). However, there is no indication that the Commission has sought and obtained "the appropriate legislation to assure that full recognition be given under the Bankruptcy Laws to assets segregated for the benefit of customers", as the July Advisory Committee Report recommended (*See*, Petition, p. 27). The Commission states that it is within its "broad authority under Section 4c(b) [of the Act] to impose this condition upon options trading, and the Courts should respect the legal relationships it establishes." (p. 19). However, this conclusory statement does not change the fact that the Commission does not have the authority to amend the Bankruptcy Act through the promulgation of regulations. Secured and general creditors would have first claim to the segregated funds in that these monies would constitute the fees and commissions earned by the dealer at the time the option was sold and would also constitute a part of the merchant's working capital, since the wholesale cost of the option would have been paid to the London Exchanges at the time the option was written. As the customer would have already received value for money in the form of the option, the actual funds segregated then would be the property of the option dealer, and not the customer. As such, a Trustee in Bankruptcy would be vested with title to the segregated

funds for the benefit of all creditors, and no preference on the part of a customer would be recognized in the absence of corrective legislation.

In a situation involving the failure of a commodity options dealer, which was in a large part the impetus for the Commodity Futures Trading Commission Act, the Commission filed an *amicus* brief in the bankruptcy proceeding and acknowledged that no cases had been found applying general trust principles to situations involving commodity options, or profits earned thereon. *In Re J.S. Love & Associates Options, Ltd.*, Bankruptcy No. 76 B-590 S.D.N.Y. 1976). Neither *In the Matter of Weiss Securities Inc.*, CCH Com. Fut. L. Rep. P. 20,108 (S.D.N.1, 1975), nor *Seligson v. New York Produce Exchange*, CCH Com. Fut. L. Rep. P. 20,029 (S.D.N.Y. 1975), cited by the Commission in support of its contention that a bankrupt Futures Commission Merchant will be treated as a trustee of segregated customers' funds supports that proposition in any respect, nor do these cases hold that options customers would receive a preference as to the segregated funds. *Seligson v. New York Produce Exchange, supra,* dealt with the entirely irrelevant matters of whether payments of variation margin by a clearing member to a clearing association may be voided as fraudulent transfers by a trustee in bankruptcy, or whether an exchange could be held accountable for actions of a clearing association in receiving such alleged fraudulent transfers of variation margin. *In the Matter of Weiss Securities, supra,* is similarly in apposite, in that that case did not involve the purchase and sale of London options, but rather the dissolution of a diversified securities firm. The Court in that case noted that the policy of the Bankruptcy Act runs counter to the

creation of priority classes, and that certain claimants who had regulated commodities accounts were merely general creditors of the estate.

The Commission cites the bankruptcies of two (2) recent option firms, *In the Matter of Sterling Industries, Inc.*, N.D.Ill. No. 77 B 4431, and *In the Matter of Palmer Trading Co., Inc.*, E.D. Ill. No. 77 B 5157, for the proposition that "financially unstable firms pose substantial risks for investors" (p. 17). However, Sterling Industries, Inc., was never a duly registered Futures Commission Merchant, and therefore never subject to the full panoply of Commission Regulation, unlike Petitioner member firms. Furthermore, Palmer Trading Co., Inc., has filed for an arrangement proceeding pursuant to Chapter XI of the Bankruptcy Act, and specifically stated in its Petition for An Arrangement that it was not insolvent. More importantly, the fact that two options firms might have had financial difficulties certainly does not prove that the customers of either firm would have been aided in any respect by the imposition of double segregation upon such firms. Finally, the Commission has stated in the Opposition Brief, that there are sixty (60) Futures Commission Merchants duly registered to sell options (p. 11). Palmer Trading Co., Inc., is the only one of those sixty which the Commission can cite as having been involved in an insolvency proceeding since the commencement of the litigation.

The Opposition Brief further states that the Commission fulfilled the duties imposed upon it pursuant to Section 15 of the Act, 7 U.S.C. 19 (Supp. V, 1975) in considering the anticompetitive implications of the double

segregation rule, and in endeavoring to take the least anticompetitive means. However, the Commission does not support this statement, other than to again recite its conclusory discussion of the anticompetitive aspects of the rules which it has published at 41 Fed. Reg. 51809. Considering Section 15 in *Murlas Brothers Commodities, Inc. v. C.F.T.C., supra,* Judge Barrington Parker of the United States District Court for the District of Columbia stated:

> "However, there can be no question that Regulation 32.6 will tend to restrict participation in the Commodity Option business to a few large firms. While the Commission apparently has the power to restrict participation in options to those firms with sufficient capitalization, such actions must be taken with cognizance of the antitrust policy of Section 19. Since other Commission regulations insure adequate capitalization of registered options dealers, the Regulation may be invalid under that Section." CCH Com. Fut. L. Rep. P. 21.969.

Finally, the Opposition Brief states that petitioners' "Central assault on the segregation requirement" is based upon the premise that customers are already adequately protected by guarantees of performance in the London Exchanges (p. 20). This simplistic statement, however, is a complete mischaracterization of the scope and depth of petitioners' challenge to Regulation 32.6. Petitioners have cited the guarantees on the London Exchanges and their unparalleled record of over a century of complete safety only to rebut the contention by the Commission that "double segregation" is necessary to protect American customers from unnamed dangers on those exchanges. *See*, 41 Fed. Reg. 44564 (1976); Petition p. 25). This contention is unrefuted in the Opposition Brief.

Therefore, the Opposition Brief states no reason whatsoever why this Honorable Court should not issue a writ of certiorari forthwith to decide once and for all the issue of the lawfulness of a novel, unprecedented regulation, which is continuing to trouble the Courts.

CONCLUSION

For the foregoing reasons, as well as those urged in the Petition, a writ of Certiorari should issue.

Respectfully submitted,

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